DRAFT

STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**02/22/06**	Bill No:	**AB 2218**
Tax:	**Sales and Use**	Author:	**Torrico**
Related Bills:			

BILL SUMMARY

This bill would, for a 10-year period beginning January 1, 2007, provide a state sales and use tax exemption (5.25 percent) for purchases of qualifying tangible personal property by trades or businesses and their affiliates, as specified and defined.

ANALYSIS

Current Law

Under current law, entities engaged in activities such as manufacturing, research and development, and power generation activities that make purchases of equipment and other supplies for use in the conduct of their activities are required to pay tax on their purchases to the same extent as any other person either engaged in business in California or not so engaged. Current law does not provide special tax treatment for these entities.

Proposed Law

This bill would add Section 6377 to the Sales and Use Tax Law to provide a state (5.25 percent) sales and use tax exemption for a 10-year period beginning January 1, 2007, for the following purchases by a "qualified person" or an affiliate of the qualified person, as specified:

- Tangible personal property for use by a qualified person to be used 50 percent or more in any stage of manufacturing, processing, refining, fabricating, or recycling of property, as specified.
- Tangible personal property purchased for use by a contractor, as specified, for use in the performance of a construction contract for the qualified person who will use that property as an integral part of the manufacturing, processing, refining, fabricating, recycling, or as a storage facility, as described.

The bill would define a "qualified person" as person who is engaged in business described in the North American Industrial Classification System (NAICS) and an affiliate of a qualified person, as specified.

The bill would specify that the proposed exemption would *not* include 1) any tangible personal property that is used primarily in administration, general management or marketing, 2) consumables with a normal useful life of less than one year, except as specified, and 3) furniture, inventory, equipment used in the extraction process, or equipment used to store finished products that have completed the manufacturing process.

The bill would define the terms, “manufacturing,” “primarily,” “process,” “processing,” “refining,” and “tangible personal property.”

As a tax levy, the bill would become effective immediately upon enactment.

Background

For a ten-year period ending December 31, 2003, the law provided a state sales and use tax exemption for purchases of equipment and machinery by new manufacturers, and income and corporation tax credits for existing manufacturers' investments (MIC) in equipment. Manufacturers were defined in terms of specific federal “Standard Industrial Classification" (SIC) codes. The exemption provided a state tax portion exemption for sales and purchases of qualifying property, and the income tax credit was equal to 6% of the amount paid for qualified property placed in service in California. Qualified property essentially was depreciable equipment used primarily for manufacturing, refining, processing, fabricating or recycling; for research and development; for maintenance, repair, measurement or testing of qualified property; and for pollution control meeting state or federal standards. In addition, certain special purpose buildings were included as "qualified property."

This partial sales and use tax exemption and income tax credit had a conditional sunset date. They were to sunset in any year following a year when manufacturing employment (as determined by the Employment Development Department) did not exceed January 1, 1994 manufacturing employment by more than 100,000. On January 1, 2003, manufacturing employment (less aerospace) did not exceed the 1994 employment number by more than 100,000 (indeed, it was LESS than the 1994 number by over 10,000), and therefore the MIC and sales tax partial exemption sunsetted at the end of 2003.

The manufacturer’s sales and use tax partial exemption for new manufacturers and the corresponding income tax credit for existing manufacturers were added in 1994 by SB 671 (Stats. 1993, Ch. 881). The purpose of that legislation was to enable California to become competitive with the 42 other states that exempted manufacturing equipment and were luring manufacturers away from California with promises of lower taxes. SB 671 was designed to provide California companies with an immediate incentive to expand their facilities and to create new jobs.

In an October 2002 report put out by the Legislative Analyst’s Office, *An Overview of California’s Manufacturers’ Investment Credit*, the following arguments against and in support of these tax incentives were presented:

Arguments Supporting the MIC

- Investment Incentive—The MIC effectively reduces the price of new capital, and leads to greater investment. Adherents of this view suggest that a firm considering a capital investment is much more likely to undertake such investment with the MIC in place. Proponents argue that this marginal cost reduction can have a significant positive impact on investment decisions.

- Relocation Incentive—California has become a more attractive place relative to other states for business since the credit has been in place. The argument here is that tax credits do influence corporate location decisions and dissuade businesses from moving their activities out of California. Manufacturing industry representatives stated and continue to state that the MIC plays an important role in both expansion and business location decisions.
- Efficient Job Allocator—Competition for business among states is an efficient job allocator. This argument holds that the nation benefits from the redistribution of jobs that may occur due to the use of investment tax credits. This is based on the notion that jobs are worth more in areas with higher unemployment, and that such areas are likely to have relatively aggressive tax credit programs. These areas will be able to attract businesses away from regions that do not value the jobs as highly.
- Other Arguments. Advocates of the MIC also emphasize that the MIC offers significant indirect benefits to the state in terms of investment and job growth that result in additional state revenues. They also point out the importance of manufacturing to the overall state economy in terms of economic stability and the high value-added nature of the employment in this sector.

Arguments Against the MIC

- Inequitable Taxation—The MIC results in giving a tax advantage to manufacturing over other business activities, as well as providing an advantage to capital investment over labor. This view holds that since only one type of industry (and production factor) benefits from the tax credit, the remaining industries face relatively higher costs, and are therefore at a competitive disadvantage. Such preferential treatment can also result in inefficient resource allocation according to this view.
- Relocation Rather Than Creation—The MIC results in few new jobs, but rather pits states against each other in competing for jobs. The argument here is that corporate tax breaks are no more than a transfer of government funds to private businesses, and in the end, the national economy is unaffected. In this view the competition among states in offering various tax incentives represents a form of "prisoners' dilemma"—in which each state would be better off if none offered such incentives. If one state does offer them, however, it is in the interest of other states to do the same.
- Inefficient Development Policy—Tax incentives have a negligible impact on economic growth and any job creation that does occur does so at a substantial cost per job. Proponents of this view also hold that some of the tax credits will go to companies which would have made the same investments, regardless of the tax incentive. That is, the tax credit did not induce the investment, yet the company receives "windfall benefits" in the form of reduced taxes.
- Ineffective Development Policy—Taxes are a very small percentage of overall business costs and thus have little effect on business decisions. Labor, transportation, land, and other factors typically constitute much more significant proportions of total costs than do taxes. Therefore, according to those who hold this view, tinkering with this particular cost is unlikely to result in a large shift or

expansion of business compared to the adverse fiscal effects that such measures can have on the state.

Since it sunsetted, numerous measures have been considered by the Legislature to reinstate or restore some type of tax incentives for manufacturers and other related industries. For example, during 2005, the following measures were considered:

- AB 80 (Ridley-Thomas) would have, beginning on the first January following the fiscal year in which the state budget deficit for the 2005-06 fiscal year is eliminated, provided for a 7-year period, a state sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities, as specified. This measure was held in suspense in the Assembly Revenue and Taxation Committee where it died.
- AB 344 (Villines) would have provided a state sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by qualified persons primarily engaged in manufacturing, telecommunications and electrical generation activities, as specified. The partial exemption would have applied to 25% of the sales or purchases for 2006, 50% for 2007, and 100% thereafter. This measure was also held in suspense in the Assembly Revenue and Taxation Committee where it died.
- AB 845 (Ridley-Thomas) would have reinstated the manufacturer's exemption but would have provided a conditional sunset date depending on the growth in employment. Also, this bill would have limited the exemption based on the manufacturers' aggregate gross assets and would have also included manufacturers other than new establishments. This bill, too, was held in the Assembly Revenue and Taxation Committee where it died.
- AB 1580 (Torrico) would have provided a state sales and use tax exemption (5.25%) for purchases of qualifying tangible personal property by qualified persons primarily engaged in specified activities, including manufacturing, construction contracting, software production, telecommunications, cable distribution, scientific research and development services, and wholesale distribution of recyclable materials. The bill would have postponed this exemption until after an unspecified date, and would have allowed qualifying purchasers to claim refunds for the equivalent amount of tax paid during the period of postponement. AB 1580 died also in the Assembly Revenue and Taxation Committee.
- SB 552 (Alquist) would have provided a state and an optional local and district sales and use tax exemption for purchases of materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, telecommunications, software production, and printing, and for semiconductor, biotechnology and pharmaceuticals cleanrooms and equipment. The proposed exemption would have applied to purchases on or after January 1, 2006, but the exemption would have been postponed until the first January 1 following the fiscal year in which the state budget deficit was eliminated. Qualified persons would have been allowed to file a claim for refund with the

Board equal to the amount of sales or use tax paid on the purchase or purchases of qualifying property, as specified. This measure died in the Senate Revenue and Taxation Committee

- SB 631 (Dutton) would have reinstated the partial tax exemption for purchases of tangible personal property by manufacturers for use in their manufacturing and research and development activities. This bill was never heard in committee.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author. According to the author's office, it is intended to stimulate California's economy by reducing the costs of capital investments in the research and development, manufacturing, and broadband industries.

2. **Technical issues:**

- The bill broadly defines a "qualified person" as a person engaged in those lines of business described in the NAICS, or an affiliate of the person, as specified. The NAICS is a system for classifying all types of business establishments. Thus, by mere reference to the entire NAICS, virtually every business engaged - even minimally – in the activities described in the bill would qualify for the proposed partial exemption. To address this issue, it is recommended that the bill be amended to incorporate specific code references of the NAICS consistent with the author's intent, and to require that the qualifying entity be *primarily* engaged in the activities described in the referenced codes.
- Another issue relates to the proposed definitions for the types of property included or excluded from the proposed exemption. For example, on page 4, lines 5 and 19, the bill refers to the items having a useful life of one year or more (or less). In order to lessen potential audit disputes, the bill should contain some mechanism for determining the useful life. Perhaps some reference to the provision in the California income tax laws for depreciating assets should be incorporated into the bill.
- On page 4, line 6, "(10)" should be replaced with "(9)" to correctly reference the appropriate paragraph.
- Subdivision (g) of proposed Section 6377 (page 5, line 31) provides for an exemption from tax for specified leases of qualified property and limits this exemption for a six-year period. This limitation is modeled after a provision in former Section 6377 that provided a state tax exemption solely to *new* manufacturers' leases of equipment. Since this bill would provide the exemption for all qualifying persons, it appears the limitation in subdivision (g) is unnecessary and should be stricken. Otherwise, long-term leases of qualifying property would not enjoy the same tax privileges that the bill would provide to actual purchases of the same property.

3. **Related measures.** Other measures that would provide a sales and use tax exemption for sales and purchases of manufacturing equipment and other related activities that have been introduced this year include:

   - AB 2395 (Villines) - This bill would provide, for calendar years beginning on or after January 1, 2006, a state sales and use tax exemption for tangible personal property, as defined, purchased for use by manufacturers that have "gross aggregate gross assets" used in the manufacturing activity not exceeding $5 million. The bill would also provide a corresponding 6 percent income tax credit on purchases of similar property.
   - AB 2595 (Arambula) - This bill would provide a state sales and use tax exemption for qualified manufacturing equipment, as defined, purchased for use by a small size manufacturer, as defined. This bill would also allow a small size manufacturer, as defined, as an alternative, to elect to take a deduction for depreciation for the entire cost of qualified manufacturing equipment in three years, as provided.
   - SB 1291 (Alquist) - This bill would provide a state sales and use tax exemption for purchases made on or after January 1, 2006 of materials, supplies, machinery and equipment used by entities engaged in manufacturing, research and development, software production, and printing, and for semiconductor, biotechnology and pharmaceuticals cleanrooms and equipment.
   - SB 1643 (Runner) - This bill would, for calendar years beginning January 1, 2007, and before January 1, 2012, allow a state sales and use tax exemption for tangible personal property purchased for use by a qualified person (new manufacturers and computer programmers and designers, as specified) engaged in the manufacturing, processing, refining, fabricating, or recycling of property, as specified and defined.

COST ESTIMATE

The Board would incur costs to administer this measure. These costs would be attributable to, among other things, identifying and notifying qualifying entities, auditing claimed amounts, revising sales tax returns, and programming. An estimate of these costs is pending.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

Although the bill states that a "qualified person" is a person who is engaged in those lines of businesses described in NAICS, it does not identify the actual codes. For this estimate, we included only those businesses classified as manufacturers (NAICS codes 31-33).

The *Annual Survey of Manufacturers 2004,* a US Census Bureau publication, specifies manufacturing expenditures for California, as follows:

California Expenditures - Year 2004

Machinery & Equipment	$ 9.7 billion
Building & other structures[1]	1.0 billion
Fuel purchases	2.3 billion
Total expenditures	$ 13.0 billion

[1]The building and other structures expenditures amounted to a total of $2 billion. However, we estimate that about half of these expenditures would amount to exempt charges for labor.

Revenue Summary

The revenue impact from exempting from the state sales and use tax qualifying property by manufacturing businesses would result in an estimated annual loss of $683 million (5.25% × $13 billion = $683 million).

General Fund (5%)	$650 million
Fiscal Recovery Fund (.25%)	33 million
Total	$683 million

Analysis prepared by:	Sheila T. Waters	916-445-6579	04/03/06
Revenue estimate by:	Ronil Dwarka	916-445-0840	
Contact:	Margaret S. Shedd	916-322-2376	

ls 2218-1sw.doc

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.